ERIKSENSGLOBAL
Actuaries & Investment Strategists

MARKET PERFORMANCE AND COMMENTARY – JULY 2021

MARKET PERFORMANCE

Index	Index Level/Price	1 Month %	3 Month %	1 Year %
Global Equities				
MSCI Emerging Markets	754.52	-6.1	-4.0	18.2
S&P 500 (US)	4395.26	2.3	5.1	34.4
Nikkei 225 (Japan)	27283.59	-5.2	-5.3	25.7
FTSE 100 (UK)	7032.30	-0.1	0.9	19.2
DAX (Germany)	15544.39	0.1	2.7	26.2
CAC 40 (France)	6612.76	1.6	5.5	38.2
Trans-Tasman Equities				
S&P/NZX 50	12594.52	-0.5	-1.1	7.4
S&P/ASX 300	83277.72	1.1	5.8	29.1
Bonds				
S&P/NZX NZ Govt Stock	1892.62	1.1	0.6	-3.4
S&P/NZX A Grade Corporate	5867.46	0.1	-0.1	-1.5
Barclays Global Agg (Hedged to NZD)	430.01	1.3	2.0	0.2
FTSE WGBI (Hedged to NZD)	3714.83	1.5	2.3	-0.9
Oil				
West Texas Intermediate Crude	73.95	0.7	16.3	83.6
Brent Crude	75.38	0.3	13.3	76.1
NZD Foreign Exchange				
AUD	0.9495	2.0	2.2	2.2
EUR	0.5886	-0.1	-1.2	4.5
GBP	0.5020	-0.8	-3.1	-1.1
JPY	76.6000	-1.2	-2.3	8.8
CNY	4.5118	-0.1	-2.8	-2.9
USD	0.6980	-0.1	-2.7	4.8

Source: Nikko

Executive summary:

- US and European equity markets rise.
- Interest rates surprisingly fell.
- NZ dollar weakened but strengthened against the AUD
- Stock markets momentum appears choppy
- Low volume of trades because of holidays and the Olympics

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ECONOMIC COMMENTARY

GLOBAL SNAPSHOT

Over the last 18 months, the Fed, Treasury and Congress have used a firehose of money to support the economy, financial markets, businesses and employment which has resulted in:

- Confidence in the prospects for a strong economic recovery.
- Skyrocketing asset prices.
- Fear of rising inflation.

Increased government spending and loose monetary policy would be expected to produce the following:

- A stronger economy than would otherwise have been the case – thanks to the COVID-19 payments to businesses throughout 2020 and domestic spending;
- Higher corporate profits – seen with the recent positive US earnings announcements;
- Tighter labour markets and higher wages – evidenced by lower than expected unemployment and rising minimum wages (in NZ);
- More money chasing a limited supply of goods – exemplified by or accentuating the lack of listings on the NZX main board, infrastructure shortages and shipping challenges;
- An increase in the rate at which the prices of goods rise (i.e., higher inflation) – look no further than global equity markets, house prices, commodities or used cars; and, eventually…
- A tightening of monetary policy to fight inflation, resulting in higher interest rates – TBC...

There is plenty to digest at this point in the cycle but fundamentally some key issues remain; earning virtually nothing on term deposits and bonds, sky high equity valuations and high correlations between bonds and equities. So, what to do? Private markets…???

LOCAL SNAPSHOT

The New Zealand Government came under scrutiny throughout July for the slow progress of vaccine roll out after it was reported we are the worst per capita in the OECD for getting jabs into people's arms. In other news, an inheritance tax is back on the cards as Labour are looking into how it may be brought back after the next election. Expect to see a shake up of the FMCG industry with grocery giants Foodstuffs and Progressives under pressure for being a duopoly with comparisons likening their relationship to the old 'Telecom' dominance.

Again, more regulation although competition is important for efficient and functioning markets. With more and more oversight, it feels like a never-ending process. On a semi-related note, the NZ government has put through 78 new bills since the beginning of 2020 – almost one per week.

The two-way travel bubble with Australia was suspended for an initial 8-week period on 23 July 2021 after an outbreak in Sydney. At the time of writing, daily new cases are trending up as the high transmissibility of the Delta variant is taking hold. This will hurt the winter tourism operators, i.e. Queenstown.

KEY ECONOMIC DRIVERS (ASSUMPTIONS)

Savings

The price of money (interest rate) in a market-determined framework is a function of supply and demand which pertains to savings and investment (borrowing). Additional quantitative easing from central banks have created excess bank reserves which are simply being reinvested into ‘risk free’ assets (saved).

One view is the excess savings ‘war chest’ accumulated over the pandemic is a huge source of future demand just waiting to be unleashed and creating a consumption boom. We are skeptical because research from the New York Federal Reserve in their monthly Survey of Consumer Expectations highlights the gargantuan multi-trillion-dollar stimulus programs unleashed in the US during the pandemic saw:

- Only around 25% was directed to: Essential/discretionary consumption; and
- The rest either saved and used to pay off debt.

It is no surprise the pandemic caused an upward shock to savings around the world. The consensus view is that this war chest will be unleashed as we move to a more vaccinated world. The New York Fed’s research has shown it won’t be that simple. Anyone living through another lockdown is being reminded of the pandemic’s uncertainty and we expect consumers to continue growing their safety buffer.

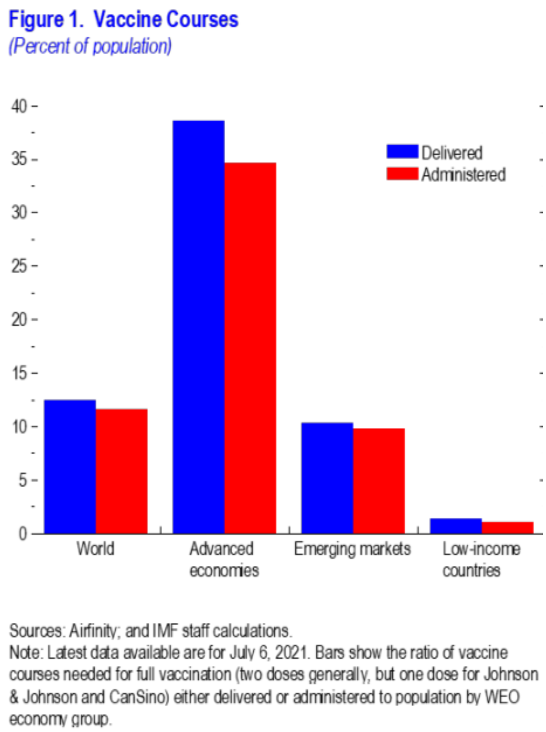
Vaccinations

Close to 40 percent of the population in advanced economies have been fully vaccinated, compared with 10% in emerging market economies and a tiny fraction in low-income countries.

Vaccine access is the principal fault line along which the global recovery splits into two blocs: those that can look forward to further normalization of activity later this year (almost all advanced economies) and those that will still contend with prospects of resurgent infections and rising COVID death tolls.

Even a world 100% vaccinated and with excess savings is still a very uncertain world – that’s about as far as consensus expectations have got, thinking it will be *el dorado* once everyone has their jabs which we see as wishful thinking. The longer-term implications of living with the virus needs to be thought through in more detail and how the markets will react to this new fact will be a tough realisation.

Figure 1: Vaccine Courses



Source: IMF

WORLD FINANCIAL MARKETS

Equities

The S&P 500 charged forward 6% in July. This exemplified equity market trends around the world throughout the month with growth stocks liking the lowering of the US 10 Year Treasury. Interestingly, during the last five trading days, volume in put options has lagged volume in call options by 49.4% as investors make bullish bets in their portfolios. However, this is still among the highest levels of put buying seen during the last two years, indicating significant divides in investor behaviour.

Fixed Interest

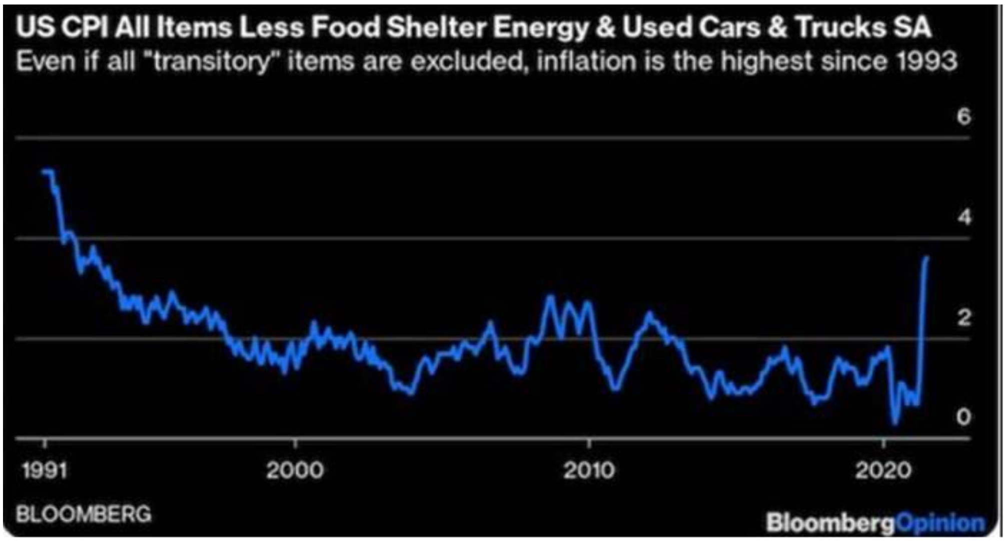
The world's most important bond market, the US 10 Year Treasury, is showing confusing signals. After reaching a pandemic-era peak of 1.74% at the end of March, the yield has fallen sharply to 1.29% at the end of July. Given the surge in reported inflation in recent months and forecasts of above-trend U.S. GDP growth in 2021 and 2022, the decline in bond yields poses a bit of a conundrum, we might have expected it to remain stable or rise higher than 1.7% given the inflation risk. Instead, the 1.29% yield is over 1% negative in real terms (after inflation).

There doesn't seem to be clear reasons for this, except for the Fed pouring cold water on fears that inflation is going to be more than transitory. There are minimal rate increases expected in the US for the next year whereas the NZ OCR is expected to jump from the current 0.25% to approximately 1%. Since our 10 Year Government Bond has been sitting around 1.48% to 1.60% over the last few months, we could theoretically expect an increase in overseas buyers of NZ dollars, strengthening our currency which is bad for exporters.

INFLATION

The debate rages on regarding whether inflation will be permanent or transitory. However, there is a huge cost riding on the answer as higher inflation would lead to higher interest rates and probably lower asset values. There are intelligent people on both sides of the argument, but we think it's impossible to really know the answer. However, in saying that, even if you exclude food, fuel, shelter and used cars/trucks, inflation is still the highest it has been in 3 decades.

Figure 2: CPI excl. transitory items



Source: Bloomberg, Schroders

We also note, the historically reported low U.S. inflation rates may be partially attributable to changes in recent decades in the way the Consumer Price Index is calculated, but the truth is that we know very little about inflation, including its causes and cures. Astute investors such as Howard Marks view inflation as "mysterious" which is a technical term. That unsatisfying answer can make life tough for investors since inflation and its impact on interest rates constitute an important wildcard for the next chapter in the financial markets.

PROMINENT THEME I: MERGERS & ACQUISITIONS

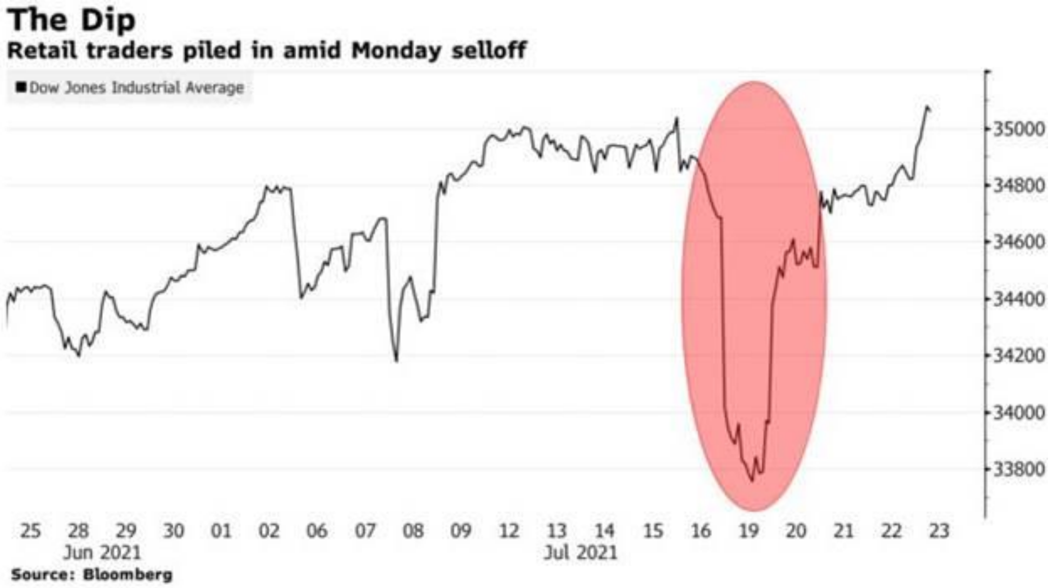
The M&A space, much like the rest of the equity market, is on fire. The first half of 2021 has seen the strongest start to the year since 1999. Over $1.85T in deals have been announced by the US-listed acquirers. Annual deal flow in the US from 2016 – 2020 added up to US$1.8T, a figure that had already been eclipsed in 2021.

A tilt in institutional investors' asset allocation towards illiquid investments has resulted in private equity and private debt funds increasing dry powder to $3T globally. This structural shift has increased the number of firms looking for acquisitions. And access to cheap, plentiful debt has amplified the situation.

PROMINENT THEME II: RETAIL & FUND FLOWS

Retail investors poured $2.2 billion into equities on Monday 26 July and were similarly active on Tuesday 27 July. A tell-tale sign of the incoming wave was a jump in Google searches of "Dow Jones". Year to date there has been $900 billion flowing into U.S. mutual funds and ETFs, which is greater than the fund flows for the rest of the world (!). This is in contrast to institutional managers who have been shifting allocations to Europe. Institutional investors have appeared sensitive to valuations towards the end of the month, for good reason – they are very high, as they attempt to capitalize on slightly better priced stocks in Europe as the re-opening commences. We also need to give credit to the retail investors for buying the dip on the 19th of July after some market turbulence.

Figure 3: Retailers Buying the Dip



Source: Bloomberg, Schroders

PROMINENT THEME III: CHINA

The South China Sea has become a further hotbed of tension for key world powers. However, it merely shows the tip of the iceberg of China's approach, after President Xi Jinping announced he wanted Taiwan united with China, by military force if necessary, by 2049 which represents the 100th anniversary of the People's Republic of China. The militarisation in the South China Sea, regarding Taiwan and broader Pacific ambitions are highly concerning for the region and global stability in the long term. Time will tell whether it's just rhetoric or whether they walk the talk, and we get the feeling they are happy to do the walking.

How New Zealand reacts to these ongoing tensions will be delicate because China is our key trading partner worth around 30% of all exports. Jacinda Ardern is walking a tight rope considering that Taiwan is also our 7th highest export partner and we have encouraged support for Taiwan's participation in multi-lateral gatherings. We are in a precarious position given our isolation and economic insignificance, as we would be an easy way for China to make an example of dissenters to their ambitions, similar to Australia's tariffs.

GEOPOLITICS

Delving deeper into geopolitics, two key topics in this space are China and the Middle East.   The Taiwanese issue became hotter during July after the Japanese Deputy Prime Minister Taro Aso stated that Japan must defend Taiwan and it is a matter of survival (assuming the next target would be Okinawa). The Chinese Communist Party (CCP) aired a video in response on official channels where they stated that they would nuke Japan if they dare to send a single soldier on Taiwanese soil. So why is Taiwan so important? Two reasons: the first being the image of CCP in mainland China that was damaged by the Kuomintang during civil war (later formed Taiwanese government) and promotion of their values. The second is the strategic

positioning of the island from a trade and military prospective. Taiwan's position in high-tech industry also adds to its value.
Is there any chance of avoiding this? The answer is no; it is just a matter of time. Retired US admiral William Owens, ex-member of chief of staff: "The ability of the west to stand by Taiwan and defend the island against an onslaught from China is very very remote in its possibility of success. If the Chinese want to do it and have made up their mind, they will do it, and the world will never be the same."

According to Ben Lowsen (former US Army officer and military attaché in Beijing) the most salient difference of interpersonal culture is subordinates' willingness to speak their mind to superiors. Free expression within the People's Liberation Army is limited by the expectation that, barring some catastrophic event, units will perform basically without error. Troops work very hard to ensure that this is the case. So in case of conflict the Chinese troops will act as a machine without any questions or hesitation.

The hardest heatwave in the Middle East has caused tensions in the region. A drought has caused political protests in Iran and disputes between Turkey and Iraq over transboundary rivers - Euphrates and Tigris. Syria and Lebanon have water supply problems as well. Gold, oil … now water.

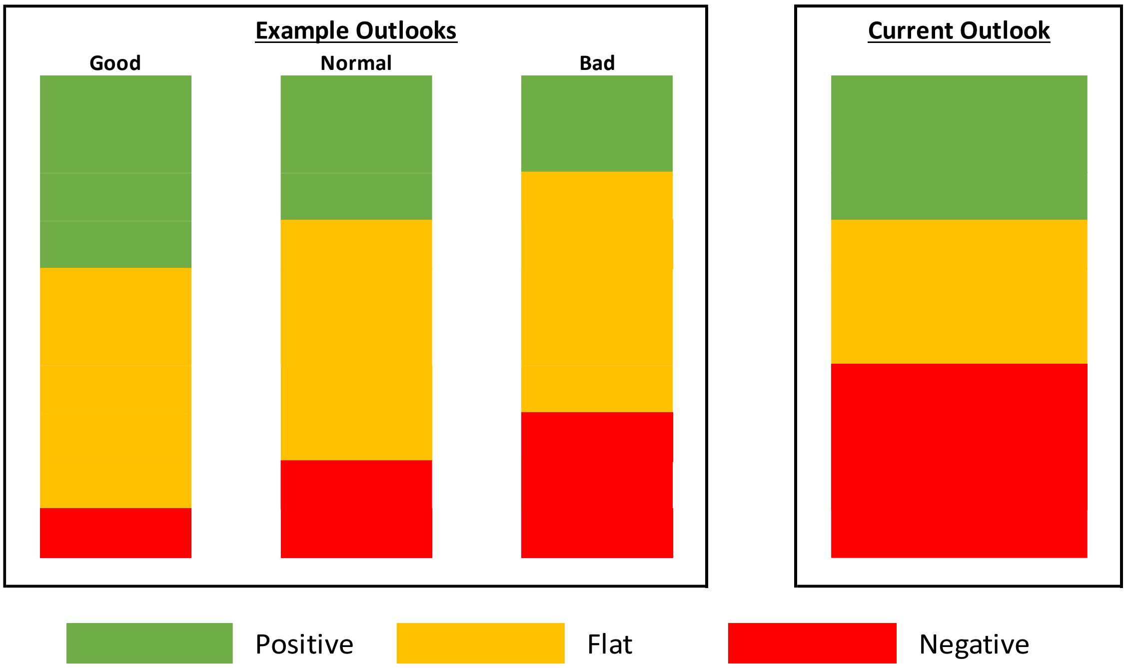
SPENDING FOR SAVING

The International Monetary Fund has warned that the world economy could lose $4.5 trillion by 2025. While inflation in most countries is expected to return to pre-pandemic ranges by 2022, long-term effects will be felt if Covid variants go unchecked.

Just under 40% of the population in advanced economies have been fully vaccinated, compared to just 11% in emerging markets and even less in low-income developing countries. Nearly 90% of African countries will miss the global vaccination target of 10% by September. More than two-thirds of projected economic losses would fall on middle-and low-income countries. To curb the highly contagious Delta variant, many governments have now resorted to vaccine mandates.

The IMF has joined WHO, the World Bank and World Trade Organization in a push to deploy more vaccines. The goal is to vaccinate at least 40% of the population in every country by the end of 2021 and at least 60% by mid-2022. This initiative would cost $50 billion. Wealthy countries are urged to share at least 1 billion Covid vaccine doses with developing nations, where economic recovery will be even slower and more painful if corrective action isn't taken.

MARKET OUTLOOK



The current market is less likely to have a good return (green) as an average return (amber) over the next two to three years. It is a little more likely to have a bad return (red).